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viewpoint

INSURANCE IN A SOFT MARKET

The cost of corporate property and casualty insurance varies dramatically as the market cycles between "hard" and "soft" periods. Smart companies of all sizes can—but often don't—maximize reductions in insurance costs by properly adjusting to these fluctuations.

Steve Lawrence

Steve Lawrence, senior consultant for Insurance and Financial Services at Watson Wyatt Worldwide in New York City, explains the options for managing the cost of liability, workers' comp and other such insurance through both cycles.

How do "hard" and "soft" cycles work?

A hard market usually lasts about two or three years, and it's marked by steep price increases and more restrictions or exclusions in coverage. During a hard market, a company's insurance premiums may go up by 100% or more.

A soft market typically runs for five years or more. It is characterized by annual reductions of 5%-10% on premiums and improved coverage for the policies purchased. We're about three years into a soft market right now.

Why do premiums fluctuate so much?

It's essentially a question of supply and demand and is driven in part by how much the insurance industry is paying out for claims related to such things as large natural disasters. When the industry makes big profits, insurers want a larger market share, which increases competition. This causes prices to fall, creating the soft market.

Eventually, the prices fall and the insurer becomes less profitable. As profitability erodes, prices go up. These increases tend to take place all at once, over the entire insurance marketplace, creating the hard market.

How can companies capitalize on a soft market?

The first step is to decide the relative importance of cost, coverage and the services of its current insurance broker. If it's important to retain your existing broker, you might ask him or her to negotiate a lower price from your current carrier. That would probably result in a 5% reduction in your premium. A second option is to ask your current broker to bid out your coverage to several underwriters, which typically would get you a 10% reduction—and perhaps better coverage too.

If your focus is on the best savings possible, you would set up a competition between at least two brokers. This could boost your savings by another 5%-10% with comparable coverage. We recommend companies consider this third option only once every three years or so. Brokers have long memories, and if you do it too often, you'll find it more difficult to find one who is willing to enter into a bidding process.

In any case, your objective is to set a new and lower baseline price from which you can negotiate a lower price next year. Your baseline stays with you until a hard market comes, and then everybody's premiums go up.

What's the best strategy in a hard market?

Significant increases are inevitable, but a bidding process can still help minimize them. You need to get ahead of the curve in a hard market by pushing for an agreement on pricing parameters two months prior to renewal. If you don't get one, you have sufficient time to bid.

In a hard market, many consider higher deductibles or greater self-insurance. You also might consider establishing a captive insurance company, assuming the cost and tax benefits outweigh the set-up and operating costs.

Do these strategies work for smaller companies as well as big ones?

We actually do more work with smaller companies, because they don't have a full-time risk manager on staff. Also, the potential cost savings to smaller organizations can be greater—perhaps 20% or more—because their broker gets paid by mostly commission and therefore has less incentive to lower your premium costs. Large companies often negotiate a fee for their broker.

How can Watson Wyatt help companies with insurance costs?

Watson Wyatt, working with the risk manager or independently, can run the bidding process. We come in at least three months before the renewal cycle and set up timelines, deliverables and specifications for brokers. We also define the brokerage fee and services the broker will provide, run the interview process and help evaluate the proposal responses. Finally, we assess the outcome and counsel companies about their best choices.

To learn more, please contact Steve Lawrence at (212) 252-8078 or steve.lawrence@watsonwyatt.com.

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